

THE HOUSEHOLD ENDOWMENT MODEL

Adopting Lessons Learned from the Nation's Top Educational Endowments

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Some leading educational endowments were able to outperform markets through various cycles depending on the level of their sophistication.¹ These endowments credit their investment performance to a disciplined and clearly defined approach of allocating to distinct asset classes. These classes include, but are not limited to, public equity, real estate, private equity, fixed income, natural resources and commodities. Notwithstanding their mandates to meet the intermediate and long-term inflation-adjusted spending needs of their respective institutions while simultaneously meeting inflation targets, these endowments were able to outperform broader indices through various market cycles with significantly less volatility.¹ This paper explores the plausibility of implementing an endowment-style approach for retail investors. We identify important issues, considerations and challenges, and suggest that there is a place for an endowment-style approach to individual investing.

Monetary Policy Fueled Asset Outperformance

The collapse of Lehman Brothers in 2008 ushered in a new policy-contingent era of investing, thereby necessitating a change in the way many investors think. The hangover effect from the housing bubble and excessive credit creation has produced an era of slower global economic growth—the slowest rebound of the post-war era. Instead, highly unconventional monetary policy became the key driver of asset prices. In fact, weaker economic data was often seen as a positive by financial markets because it ensured continued stimulus.

The U.S. Federal Reserve first introduced low interest-rate policies and quantitative easing (purchasing of Treasury and mortgage-backed securities) in order to stabilize markets and delay painful debt restructuring. The policy playbook was soon copied by monetary authorities in England, Japan and the Eurozone. In turn, this central bank-provided liquidity powered sharp stock market rallies around the world, yielding improved tax receipts while simultaneously lowering government borrowing costs.

Accommodative financial conditions tend to favor borrowers, who benefit from lower debt service costs, to the detriment of yield-starved savers. The 10-year U.S. Treasury, for example, sunk to an all-time low yield of 1.43 percent in July 2012. Savers trying to wait out the Federal Reserve, expecting interest rates to inevitably rise, have thus far been disappointed. After a brief spike in yields in 2013, rates around the world fell in 2014—even as the U.S. Federal Reserve purchased fewer bonds each month under its gradual taper strategy. When rates eventually rise and normalize closer to long-term historical averages, prices on fixed income assets will decline. With leading central banks around the world in uncharted territory, stocks levitating at or near record highs, and bond yields at depressed levels, where do financial advisors and long-term investors look for guidance?

¹Mebane T. Faber and Eric W. Richardson, *How to Invest Like the Top Endowments and Avoid Bear Markets* (John W. Wiley & Sons, 2009)

U.S. GDP growth since the end of the Great Recession



10-year Treasury yields since 1960



Household Endowment Model

Now more than ever, the investment philosophy and asset allocation techniques of influential endowment funds may be particularly insightful. This is why we have adapted the classical institutional Endowment Model to meet individual investors' unique needs in what we term the Household Endowment Model.

The origins of the Household Endowment Model can be found in the Endowment Model, a term coined to describe the asset allocation practices employed by some of the nation's leading university endowments. Educational endowments, particularly those of Harvard, Yale and Stanford universities, have long and distinguished track records that have outperformed major indices and benchmarks through many market cycles.¹ Those university endowments with assets in excess of \$1 billion are often

referred to as super endowments. These elite entities have successfully translated ivory-tower academic theory into real-world investment success. As a result, the moves and strategies of the super endowments are closely scrutinized. These endowments credit their investment performance to a disciplined and clearly defined methodology of allocating to distinct asset classes. These classes include, but are not limited to, public equity, real estate, equity, fixed income, natural resources and liquid commodities. Notwithstanding their mandates to meet the intermediate and long-term inflation-adjusted spending needs of their respective institutions while simultaneously meeting inflation targets, these endowments have also outperformed broader indices with significantly less volatility through various market cycles.

Yale Endowment Highlights²

\$7b

During the decade ending June 30, 2013, Yale's investment program added \$7 billion relative to the results of the mean endowment.

12.5%

The Yale Endowment generated a 12.5% return in fiscal year 2013, producing an investment gain of \$2.29 billion.

11%

With annual net 10-year investment returns of 11%, the Yale endowment performance exceeded its benchmark and outpaced institutional fund indices.

6x

The Yale Endowment's 20-year record of 13.5% per annum produced a 2013 Endowment value of over six times the 1993 value.



Is there a place for a personal finance implementation of an endowment investing approach? The demonstrated performance of these endowments naturally begs the question of its applicability at the individual investor level.

Although some aspects of endowment-style investing are transferable, there are factors unique to individual investors that must be accounted for when considering an implementation of the endowment approach. A financial endowment is a transfer of money or property donated to an institution, usually with the stipulation that it be invested, and the principal remain intact for a defined time period. Endowments have limited liquidity needs, significantly long investment horizons and the ability to pursue less liquid

asset classes more aggressively. In contrast, individuals have higher liquidity preferences (often necessitated by unplanned life events) and a finite investment horizon that is closely linked to one's particular circumstances.

The goal, therefore, should not be to simply copy the leading university endowments, for they differ from individual investors in many important respects. We highlight a few reasons next.

²<http://investments.yale.edu/> & http://investments.yale.edu/images/documents/Yale_Endowment_13.pdf

Liquidity

Liquidity needs for traditional endowments are vastly different than for individual investors. Endowments and the institutions they benefit are managed on the basis that they will exist in perpetuity. As a result, liquidity is not a major priority as the endowment is tasked to provide enough inflation-adjusted annual income to support operations. These distributions are determined by specific spending policies, which also allow for some flexibility and are often augmented by generous gift income. Because these limited spending policies dampen the consequences of portfolio volatility, portfolio managers gain the freedom to accept greater investment risk with the expectation of achieving higher returns without exposing the institution to unreasonably large probabilities of significant budgetary shortfalls. Individuals do not operate in this manner. They have a limited life span and spending needs can be highly uncertain, thereby resulting in different liquidity preferences.

Valuation and Pricing

Valuations of portfolio assets also present a hurdle. The combination of liquid and illiquid asset classes in the traditional endowment model make accurately valuing such assets difficult and costly. Endowment trustees do not manage their portfolios on a month-to-month basis. As such, the reliability of a net asset value (NAV) in any given month is not of critical importance. In contrast, current and precise valuation is of particular importance when individual investors have to undergo tax and/or estate planning—issues that do not apply to endowment trustees.

Transparency

A corollary to the pricing and valuation issue is investor transparency. Because of the highly illiquid and proprietary nature of certain endowment portfolio investments, it can be difficult to ascertain precise allocations at distinct points in time. While endowments may be comfortable with the proprietary advantage that manager secrecy may create, transparency is of paramount importance for individual investors.

Taxation and Tax Reporting

Endowments do not pay income tax. In contrast, taxation and tax reporting are concerns that individual investors are not only tasked to do, but obligated to perform under state and federal laws. As a result, individual investors are often sensitive to high-turnover strategies that produce a disproportionate amount of short-term capital gains within their taxable investment accounts. Others are reluctant to accept the delay associated with the issuance of schedules K-1 often attached to certain types of real-asset structures. In some cases, these investments may even necessitate multiple state filings.

Size

Endowments, given their large size, can negotiate special arrangements directly with investment managers and often gain early-stage access to promising strategies. While individuals may be eligible to join with other investors as part of a pooled vehicle, they usually cannot access many of these investments on their own or enter into agreements with product sponsors that may only be available for institutional investors.

Longer Lives

In theory, universities can live indefinitely and therefore have a much longer investment horizon than an individual. Harvard, for instance, has been around since shortly after the Pilgrims landed on Plymouth Rock. Because of that longer time horizon, elite endowments typically depart from the traditional liquid stock-and-bond mix by allocating a significant portion of their assets to less liquid, often non-publicly-traded alternative investments such as venture capital, private real estate, managed futures, natural resource partnerships, and oil and gas.

Individual investors, therefore, require the re-tooling of the purist endowment model to meet liquidity, valuation and tax preferences, and incorporate finite time horizons. Given these limitations, the aim is to mimic—not replicate—endowment-style returns while simultaneously addressing unique retail investor needs.

Innovation by Combination

It is possible to learn from the leading endowments, the same way that we borrow recipes from top chefs or swing tips from the world's best professional golfers. Even endowments themselves learn from their own experiences. For example, in a desire to better plan for extreme events after the 2008 financial crisis, a number of endowments enacted policies to hold more cash in their portfolios and secure access to credit lines in order to meet their schools' short-term rainy-day obligations.

Innovation is often defined as doing something new with something old. It is assembling things that already exist in a different way, such as combining a roller skate with an ice skate to create in-line skates. The Household Endowment Model is simply a way of combining what we have learned from leading university endowments married with sound personal financial planning and investing techniques.

In many respects, the planning exercise that endowments themselves engage in is not all that different from our own. The managers of these funds are expected to take the long view, recognizing that today's decisions will impact future generations of students, faculty and alumni. At the same time, many institutions depend on their endowments to help fund important operating expenses within the total university budget. Endowment funds attempt to construct portfolios that support some pre-determined annual rate of spending (often 4 percent to 5 percent) plus inflation and administration costs without violating the corpus set aside specifically to produce a long-term nest egg for the university. Or said differently, leading endowments have gotten very good at making their funds work for them today without sacrificing tomorrow by outpacing their spending needs and inflation.

The Three Pillars

How do they do that? Well, there certainly is not a one-size-fits-all approach among endowments, but a common composite sketch emerges from analyzing the leading university endowments. Three investment pillars are typically present in the portfolios of the super endowments. The Household Endowment Model relies on these three pillars but incorporates a few twists—tailoring each of them to fit the needs of individual investors rather than large universities.

HOUSEHOLD ENDOWMENT MODEL



READY ALLOCATION (Tactical Management)

Flexibility to adjust the allocation to play offense in a rising market or defense in a falling market



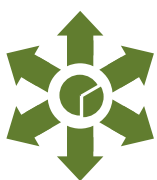
STEADY ALLOCATION (Advanced Diversification)

A sophisticated, fully diversified core with exposure to multiple equity, fixed-income, and alternate asset classes that serves as the first line of defense



HEADY ALLOCATION (Manager Selection)

Populating investments with skilled managers, unique strategies, and innovative building blocks that provide the opportunity for out-performance, or "alpha"



Steady Allocation

The first pillar is wide diversification, achieved by assembling multiple asset classes that behave differently under a variety of economic, market and political conditions. Traditional endowment portfolio fiduciaries place asset allocation at the heart of the investment process. Satisfaction of long-term institutional goals depends in large part on the underpinnings of successful asset allocation and diversification to produce an acceptable level of risk. The optimal allocation for each endowment is based on its long-term goals, assumptions and projections. It will thus change infrequently and is typically revisited annually. This pillar is thus sometimes also referred to as a strategic allocation, maintaining at least some exposure to each asset class across all market conditions. In the Household Endowment Model we prefer a simpler term, calling it an investor's Steady Allocation because the mix of assets is built for an investor's long-term goals such as growth or income. It can and will change, though, over time in response to an investor's major life changes such as retirement.

You can think of the Steady Allocation like a recipe that guides a chef, specifying how much of each ingredient or exposure to an asset class is required over the long term.

Endowment managers refer to this recipe card as their policy portfolio. It serves as both a theoretical starting point and an eventual measuring stick for value-added contributions.

What would the overall return of the portfolio be if the endowment simply earned the return of each asset class, represented by an appropriate passive index? The return of each asset class under this baseline approach depends entirely on the direction of the market. You are assured the market return for each individual asset class—no more, no less. This is known as systematic or beta market risk.

In some respects, this pillar is a scientific exercise that loosely resembles chemistry, creating the optimal formula or allocation of investments by combining different sources of risk and return based on each university's risk profile and objectives. But managers of leading endowments acknowledge that there is quite a bit of art form involved as well. Managers must also make forecasts and judgments because relationships between various investments can change over time and under various conditions. Endowments, therefore, skillfully blend both art and science to create a theoretical policy portfolio. In much the same way, a skilled financial advisor backed by a team of expert professionals can help construct similarly diversified asset allocations based on each client's individual objectives.



Ready Allocation

In an attempt to improve on their baseline policy portfolios, some endowments will periodically rebalance by shifting more funds to out-of-favor asset classes, employing a deep-value contrarian approach that increases those beaten-down asset classes back to their long-run strategic allocation weighting. Others move funds between asset classes based on valuation concerns or market outlook. This type of fine-tuning is often referred to as tactical investing and it represents the second pillar of the Household Endowment Model. A tactical investment strategy attempts to adapt to, and opportunistically capitalize on, changing market conditions, including adjusting to tail-risk events. In the last five years, markets have often been highly correlated, reducing some of the benefits of traditional diversification. Endowments often cast a wide net of diversification, not only by asset class but also by strategy and manager within asset classes. The result is a portfolio that combines elements of traditional strategic allocation with tactically unconstrained approaches.

In the Household Endowment Model, we call this second step the Ready Allocation. Having the ability to play offense or defense across asset classes is particularly important for individual investors who don't have an unlimited time horizon to recover from large losses. Imagine how a chef must react while preparing a meal—tweaking a recipe to adjust for food allergies or to replace an ingredient that has unexpectedly gone up in price.

But implementation requires a modification from the approach used by the super endowments, as individuals must take into account the tax consequences of portfolio tweaks. In addition, households often own assets in multiple taxable and qualified accounts (IRA, 401(k), defined benefit, etc.). While these multiple accounts should reflect a household's overall long-term Steady Allocation, it can be difficult and inefficient to make tactical allocation shifts across different account types and registrations. Therefore, the Household Endowment Model treats tactical adjustments as a special Ready ingredient in the overall Steady portfolio recipe, allowing financial advisors to place higher-turnover strategies in tax-deferred accounts. Being able to take evasive action to preserve capital becomes even more important for individual investors in a world where stocks are trading near all-time highs and bond yields remain anchored near record lows.

Heady Allocation

Endowments try to further improve on the returns of the long-term Steady Allocation through manager selection. That brings us to the third and final pillar used by leading endowments—smart sourcing. This is merely shopping for the highest-quality ingredients called for by the recipe in the Steady Allocation. We refer to this final piece as the Heady Allocation. The dictionary defines heady as “marked by good judgment or shrewd.” Think of the recipe for a Greek soup as a combination of cheap (beta) and valuable (alpha) ingredients.

Cheap Beta: For some staple elements of a recipe, a chef selects low-cost ingredients where there is little distinction between brands—think of milk or flour. In the same way, endowments are willing to select low-cost index instruments for certain asset classes where there is little advantage due to great market efficiencies. In the short-term Treasury market, for example, there is little separation between manager performance. Some super endowments also rely on low-cost solutions for inflation-protected Treasury securities.

Valuable Alpha: But for parts of the recipe where there is great variation in quality (think truffles, cheese, chocolate, Kobe beef, etc.), a highly-trained chef will insist on premium ingredients, often scouring markets for the freshest shipments from specific vendors. In much the same way, super endowments have been leaders in identifying the most inefficient segments of the market where returns vary widely between managers. These potential mispricings create opportunities for talented active money managers to capture alpha, or skill-based returns. Endowments go to great lengths to quantify managers’ risk-adjusted performance skill over and above the market’s return. Although alpha is much less predictable than beta, and is hard to find in the crowded hyper-competitive investment landscape, combining multiple managers who stand out from the crowd (and therefore whose strategies often have little overlap with each other) is an important way to reduce portfolio risk.



For some of these premium alpha opportunities, many endowments turn to alternative investments, typically substituting things such as private real estate or timber not listed on a stock exchange for a portion of their fixed-income and domestic equity holdings. Real estate, for example, provides them with relatively predictable cash flows with less interest-rate risk, and perhaps some upside, while also creating an inflation hedge in some instances. Because of their long-term approach, super endowments are often willing to accept the cyclical volatility of real estate and give up the ability to immediately convert properties to cash in exchange for enhanced long-term returns, thereby capturing the so-called illiquidity premium by getting paid to wait. Like everything in investing, there are tradeoffs and by holding fewer Treasury bonds, an investor may not capture the short-term, flight-to-safety benefit that sovereign bonds have historically provided during market shocks.

Patient individual investors with diversified holdings or income sources may also be well-equipped to sacrifice some liquidity and share price transparency for higher current income across a gamut of illiquid alternative investments. Such a decision is a preference based on individual lifestyle needs. Historically, these kinds of vehicles were only available to institutional investors and wealthy individuals. Today, qualified investors can access hard assets, such as real estate, leased equipment and energy resources as part of a pooled portfolio through direct-investment programs offered by professional financial advisors. An advisor can explain the risks associated with more illiquid direct alternative investments. Individual investors willing to make a long-term commitment, usually lasting from seven to 12 years, can own a piece of the properties and may realize higher-yielding income from the underlying assets. Financial advisors can also assist individual investors in addressing personal liquidity needs by allocating instead to liquid alternative mutual-fund vehicles in an attempt to gain similar exposures.

Identifying alpha or heady strategies is certainly not confined to alternative investments, though, and also applies across many of the traditional asset classes in the Steady Allocation. There are managers and strategies that have consistently demonstrated the ability to rise above the haze to Heady levels and can be accessed through mutual funds, ETFs or separately managed accounts. This includes identifying tactical macro managers with flexible, unconstrained mandates who can provide the Ready portion of the long-term Steady allocation. Super endowments benefit from large teams of in-house investment professionals conducting sophisticated manager research. A skilled financial advisor also plays an important role in identifying and monitoring Heady managers and programs on behalf of individual investors. They help investors understand the role of each manager in the portfolio and the decision to use premium or generic ingredients to satisfy the Steady recipe.



Sophistication for Individual Investors

While the investment landscape has changed, we can learn from the success of super endowments by better understanding what makes them successful. Individual investors have many shared basic goals with endowments— income generation, meeting future liabilities and growth over the long haul, for instance. But, because individual investors are different from university endowments in many ways, we must adjust the endowment methodology to apply to individual households. The Household Endowment Model proposes a similar three-pillar approach.

First, a full or sophisticated diversified portfolio should stand as the core. We simply refer to this as the Steady portion, which allows for diversification to serve as the first line of defense in managing risk.

Second, because markets are fluid we integrate a tactical element that allows for flexibility to adapt to changing conditions. We refer to this as the Ready portion, which permits the portfolio to tilt to take advantage of themes or to play offense or defense.

Third, we introduce managers who attempt to outperform the market through security selection, market timing, proprietary deal access and other ways to fulfill various asset classes. We call this Heady portion, which allows for alpha as the managers take advantage of investment dislocations as they arise.



Conclusion

This paper explored the applicability of an endowment-style approach to investors in the retail investing space, discussed specific issues unique to individual investors and suggested how multi-asset class model portfolios may be constructed. Understanding the differences between endowments and individual investors allows discerning advisors to determine the tools, vehicles and techniques that can successfully translate the success of endowment investing down to the household level—thereby better addressing individual retail investors' special investing needs.

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